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Journal Of Investment Management, Vol. 1, No. 2, (2003), pp. 73–75

CASE STUDIES

"Case Studies" presents a case pertinent to contemporary issues and events in investment management. Insightful and provocative questions are posed at the end of each case to challenge the reader. Each case is an invitation to the critical thinking and pragmatic problem solving that are so fundamental to the practice of investment management.

Jack L. Treynor

THE GAUNTLET

The morning meeting was an institution at Grosvenor Capital. Each analyst and portfolio manager had his(her) appointed place at the long boardroom table. Each was given the opportunity to speak, starting with the most junior and proceeding around the table to the most senior.

It was, as the professional staff all recognized, an opportunity to make an impression. On the other hand, many a junior analyst's brain child had failed to make it around the table. One way to make an impression, after all, was to point out flaws an idea's author had failed to recognize.

The whole point of the exercise, of course, was to screen out all but the most practical of the staff's ideas. In this way, Grosvenor minimized the risk of trading on ideas that were conceptually flawed.

Grosvenor's holdings were often popular with other investment institutions who were, in effect, expressing a vote of confidence in Grosvenor's judgment. But, of course, when a popular idea was invalidated by developments none of these investors had anticipated, the price impact was dramatic.

To demonstrate the soundness of Grosvenor's approach to clients, senior management had asked Diogenes Smith, a young addition to the professional staff, to compare the performance of accepted ideas and rejected ideas. His preliminary review had yielded two surprises:

1. the "practical" ideas Grosvenor accepted got into market price almost before the firm could trade on them;
2. in contrast to the practical ideas, there was almost no market reaction when the rejected ideas failed.

Recognizing that one could easily jump to the wrong conclusion, Smith resolved to broaden his study before seeking an audience with management. But he was uncertain how to proceed.

Questions

What determines how fast an idea gets into the consensus?

Why is it that the prices of the affected stocks do not collapse when the "impractical" ideas fail?

How big is the risk in trading in an impractical idea?

If one divides the population of investors into *other directed* and *inner directed*, which group will be more successful?

Which kind will get promoted at a firm like Grosvenor?

What kind of ideas would Grosvenor's clients like?

Which kind of investor will Grosvenor's clients be more comfortable with?

You are Diogenes Smith, ambitious for advancement and eager to fit in. What do you tell management?

Discussion

Let

p be the fraction of investors who respond to the new insight and think it is going to succeed,
g the insight's actual degree of success,
V the value of an insight if it succeeds, and
x the price adjustment that reflects the two kinds of active investors: those betting on the success of the new insight and those betting against it.

The former's position is

$$p(V - x).$$

The latter's is

$$-(1 - p)x.$$

The market clears when the two active positions sum to zero:

$$p(V - x) - (1 - p)x = 0$$
$$x = pV$$
$$\frac{x}{V} = p$$

Evidently, the fraction of the insight's value already reflected in the share price equals the fraction p of investors who are betting on it.

If in the event the insight actually achieves a fraction g of its anticipated value V, then the investor who bet on it realizes (gV) less what he paid (x) or

$$gV - pV = (g - p)V.$$

Whether he gains or loses on his bet depends on

$$g - p.$$

This suggests that the fraction of investors already on board is as important to the investor as the insight's ultimate degree of success.

To pay off now, an idea must be technically and economically feasible now. Is the economic potential big? Have some tough technological problems been solved? Then, investors can be understandably excited. But it takes only one unsolved problem to defeat (or indefinitely delay) an exciting new idea. And unsolved problems are not solved by appeals to economic arguments: the probability of solution next year (if they are not solved this year) is the same as the probability of a solution this year. A classic example is fusion power: enormous economic potential, safe (no Chernobyls), clean (no radioactive waste), great for the environment (no global warming). When fusion's last problem is ultimately solved, however, investors will be as surprised as everyone else.

These considerations suggest that the gauntlet is probably not very useful for predicting whether a new idea will have an early investment payoff. But it can still be useful for sampling an idea's popularity with investors. The payoff to Grosvenor depends on which way it uses the gauntlet.

Consider the simplified case where the insight either

1. fails or succeeds ($g = 1$ or 0), and
2. is either fully in the price or not in the price ($p = 1$ or 0). Then, the outcomes are as follows:

		p	p
		0	1
g	0	0	-1
g	1	1	0

If it equates popularity with the gauntlet as measuring the likelihood of success, Grosvenor will bet only when the insight is popular. The table shows that, if the insight nevertheless fails, the best possible outcome is breakeven; the worst is a big loss. If instead Grosvenor interprets popularity with the gauntlet to mean the insight is already in the price, it will bet only when the insight is unpopular. Then, the best outcome is a big gain; the worst is breakeven.

As a device for making investment decisions, the gauntlet is neither good nor bad. But clients may not understand how to use it. Then, the best *marketing* use of the gauntlet may be in direct conflict with the best *investment* use.

But is that a problem? If the clients do not know what the outcome of the gauntlet was, is not the firm then free to make the best investment decision? Young Diogenes should explain to his superiors that he now understands why the gauntlet is such a powerful research tool, that institutional investing is even more subtle than he realized and that he is thrilled to be associated with a firm that has so much to teach him.

I would like to thank the following people for their input in forming the gauntlet piece: Peter Williamson (discussion leader), Jim Farrell, Bob Hagin and Walter French.